AZIMUT
DEFINING INVESTMENT DIRECTION

AZIMUT GLOBAL VIEW

23.
01.
23

Main Events

PERSONAL SPENDING — 27.01
Retail sales in the past two months decreased, while personal spending continued to grow. Which of the two will prove to be wrong?

EU CPI — 01.02
The sharp decline in energy prices is expected to allow a further material decrease of inflation in the EU

FED FOMC — 01.02
More than the size of the hike (25 or 50 bps), it will be crucial to see whether the Fed will maintain its stance of keeping rates at a high level for some time

US PAYROLLS — 03.02
The continued decline in weekly jobless claims suggests that the labor market continues to remain very tight

Azimut Global Network

- Milan
- Abu Dhabi
- Austin
- Cairo
- Dubai
- Dublin
- Hong Kong
- Estoril
- Istanbul
- Lugano
- Luxembourg
- Mexico City
- Miami
- Monaco
- New York
- Santiago
- São Paulo
- Shanghai
- Singapore
- St Louis
- Sydney
- Taipei

NO REST FOR RATES

- **The decline in yields that occurred in this first month of 2023 exposes risk-free rates to some vulnerabilities in the coming weeks**
- **Reshoring, risks of under-supply of commodities, China's reopening, and a massive sovereign bond issuance coupled with QT could prevent rates from falling as much as the market currently expects**
- **As such, a final surge in market rates is possible in the short term followed by a subsequent, but shallower-than-expected, decline. Duration still needs to be actively managed in 2023.**

The beginning of a new year is typically heralded by a dramatic rebound of everything that experienced the most severe declines, as is frequently the case following bad years.

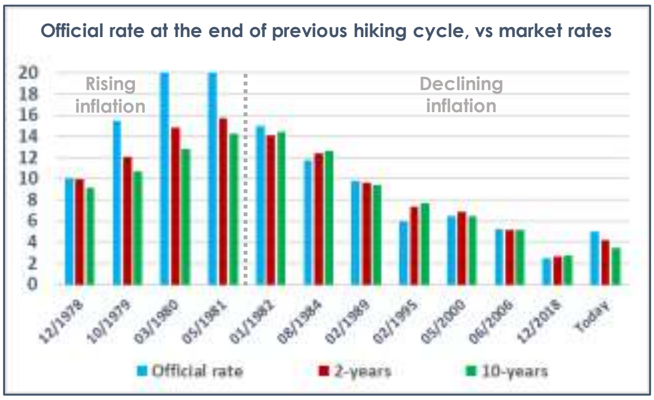
The year 2023 was no exception. Equity markets were broadly positive, with China and Europe continuing the bullish trend that began in the last weeks of 2022 from multi-year lows, while in the United States the rebound was led by the Nasdaq. Cryptocurrencies also experienced a euphoric start to the year with Bitcoin up about 40 percent.

Even more remarkable was the performance of bonds, considering that they are supposed to be less volatile: European corporate bonds rose 3%, and US bonds 3.5% (both investment grade and high yield). Ten-year government bond yields fell as much as 55 bps in the US (bond +4%), 60 bps in Germany (bond +5.5%) and 100 bps in Italy (bond +8.5%).

The benign inflation data that have been released in Europe and the United States, which were correctly predicted in the previous report and the main reason for the decline in rates, have stoked expectations of a quick return of inflation to acceptable levels and of central banks ending the cycle of rate hikes earlier and at lower terminal rates.

(continued)

Source: Bloomberg



Source: Azimut, Bloomberg

After such a sharp drop in risk-free rates in a very short period, what should we expect in the medium term?

The market is currently pricing in that U.S. rates, after peaking around 5 percent within three months, will be cut by about 2 percentage points in just over a year from the end of the rate hike cycle. We have expressed in previous reports that the Federal Reserve never ends a hiking cycle before inflation has fallen below the level of official rates.

But, where do market rates stand relative to official rates when the rising cycle comes to an end? We can see that prior to 1982, thus in a phase of rising inflation, Fed Funds rates were normally well above the 2-year and 10-year rates. This can be explained by the fact that the Fed wanted at all costs to stop runaway inflation, and to achieve the goal, it consciously raised rates to extreme levels. The market was aware of this, and knew that those official rates could not be sustained for very long. As a result, the two-year and ten-year remained well below Fed Funds. On the other hand, during the subsequent disinflationary phase, market rates were consistently at levels that were either very close to or higher than official rates, because it was credible that those rates could remain there for some time.

Today, we have already entered the disinflationary phase, and official rates are not at disproportionate levels. Therefore, it would be reasonable to expect that when official rates peak in a few weeks, the 2-year and 10-year rates will not be too far from Fed Funds. If we assume that official rates are raised only to 5 percent (50 basis points above current rates, a very dovish estimate), a 2-year rate of 4.1 percent (90 basis points below 5 percent) and a 10-year rate of 3.3 percent (170 basis points below 5 percent) seem perhaps too low. The risk, then, is that there will be one last round of increases in market rates before government bonds can be bought lightly.

Although there have been some recent openings by a few Fed governors to consider a more moderate pace of rate hikes, all have confirmed their intention to keep rates at the terminal level for an extended period, thus explicitly debunking the market's assumption of 200 basis point cuts in the near future. Even if, after reducing the pace of rate hikes from 75 to 50 basis points in December, the Fed shifts to 25 basis point hikes, at least two more hikes can be expected in February and March, bringing official rates to (at least) the 5 percent we previously predicted.

Rates fell in Europe as a result of an unconfirmed rumor that the ECB is considering moving to 25 basis point hikes rather than the series of 50 basis point hikes announced in the December press conference. This speculation was denied by Lagarde and ECB members at the World Economic Forum in Davos. It was reiterated that there will be at least two 50 basis point hikes before considering a move to 25 basis points and that the cycle of monetary tightening will end no earlier than summer. Such a strong rally in European bonds (and BTPs in particular, with rates falling below the December ECB meeting, when the ECB surprised the market by announcing the start of QT in addition to the series of 50 basis point hikes), seems therefore to be groundless.

Therefore, focusing on the short term, bonds may be vulnerable to another correction, considering that history suggests that market rates are currently too low relative to where they should be when hiking cycles end, and the central banks' insistence on warning the market against being overly optimistic about rates.

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But also in the medium term, the outlook may not be as bright as hoped for. It is reasonable to assume that market rates will decline in the second half of the year, but probably not as much as expected. There are four factors at play for why official and market rates may remain at structurally higher levels than those of the past decade.

The first one is that in the aftermath of Covid-19, firms realized how vulnerable they would be if the mechanisms underpinning globalization jammed. Difficulties obtaining raw materials or intermediate goods as well as delays in delivery will encourage "reshoring", or the practice of bringing a business moved abroad back to the country where it was originally relocated. Since globalization has fostered the offshoring of production to countries with lower input costs, reshoring will have the opposite effect, raising average production costs and therefore, leading to structurally higher inflation.

Covid-19 and the war in Ukraine have highlighted another vulnerability, which should also lead to higher inflation. In case of widespread concerns about the availability of certain commodities, countries that are in surplus and thus natural exporters may consider keeping a larger share of their commodities for themselves as a precautionary measure. To date, this has been observed particularly for agricultural commodities: after the outbreak of war in Ukraine and the sudden reduction in food availability, there has been a further reduction in agricultural commodities available for international trade as some countries have reduced their exports. This dynamic is allowing commodity exporting countries (typically emerging countries) to increase their pricing power over importing countries (typically developed countries). In other words, it is becoming evident that compared to a past when Western countries imposed themselves by printing unlimited amounts of currency and imposing them on emerging countries in exchange of commodities (and cheap labor cost), in the new equilibrium that is forming those who own raw materials (which are not "printable" at will and limitless) are seeing their bargaining power increase.

The third reason why inflation may not fall as quickly as expected is the ongoing reopening in China, along with the fiscal measures enacted to support the real estate sector and the economy. If China does indeed restart its engine, its incremental demand is expected to lead to heightened price pressures. China-driven price pressures are likely to remain subdued in the first part of 2023, but could intensify in the second half of the year.

The fourth factor is the net supply of bonds. According to an estimate by Bank of America, during 2023, G4 governments will need to issue $6 trillion of bonds. It should be noted that over the last decade, the Federal Reserve has purchased the majority of new government issuance through QE (in the graph below left, the blue and orange bars rise similarly), whereas the ECB has purchased far more sovereign bonds than those issued by EU Governments (in the graph below right, the blue bars rise much faster than the orange bars). In the absence of QE by central banks, the $6 trillion to be issued by the G4 countries will have to be entirely absorbed by the market. That's not all. Central banks in 2023 will also be net sellers of government bonds because of QT. The Fed alone will sell more than $1 trillion of treasuries, to which must be added the government bonds that will be sold by the ECB and BoE.

Source: Azimut, Bloomberg

Source: Azimut, Bloomberg

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It is reasonable to expect that at least part of this huge amount of bonds will be bought by retail investors, lured by the highest yields in a decade. But they will probably not be able to absorb the whole global issuance. And even if they do, this means that purchases will be made at the expense of other asset classes (which will have to be sold).

In summary, considering that central banks have not yet finished their cycle of hikes, it is possible that in the short term market rates will resume their upward trend, as they usually tend to do until that moment. From then on, it is reasonable to expect that risk-free rates may decrease thanks to falling inflation and growing fears of a recession. But the market is pricing in too pronounced a drop in rates, considering the dynamics just discussed. In short, another year in which duration must be actively managed to protect portfolios.

Asset Allocation View

	−	=	+
Equity			
Developed Markets		■	
Emerging Markets			■
Fixed Income			
Developed Markets Sovereign	■		
Developed Markets Corporate		■	
Emerging Markets		■	
Commodities		■	
Currencies		*Commentary below*	

− UNDER = NEUTRAL + OVER

Equity

Developed Markets

UNDER OVER
NEUTRAL

We kept our **Neutral** recommendation on Developed Markets Equities. As mentioned in the previous report, the market continued in its bullish trend thanks to lower rates and the tactical buying that usually takes place at the beginning of the year on everything that fell the most in the previous year. Further increases are possible only if the reporting season proves better than expected, and the Federal Reserve raises rates by only 25 bps or no longer mentions the need to keep rates at a high level for an extended period of time.

US	=	**Europe**	=	**Japan**	=

Emerging Markets

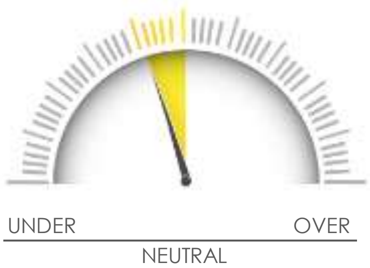
UNDER OVER
NEUTRAL

We maintained our **Slightly Overweight** recommendation on Emerging Markets Equities. Given their still-low absolute and relative valuations and the possibility of an upcoming dovish pivot from Western central banks, emerging market equities still have room to extend the rebound of the past weeks. This is particularly true for Chinese equities, which may outperform other emerging countries due to the numerous support measures approved by the Chinese government in the past two months. In light of this, we continue to prefer the Asia ex-Japan region.

Asia ex-Japan	+	**EEMEA**	−	**LATAM**	=

Fixed Income

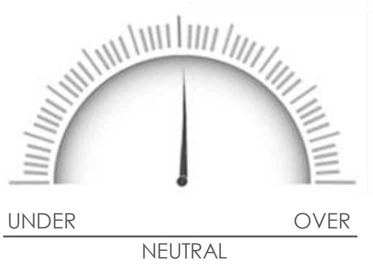
Developed Markets Sovereign



We maintained our **Slightly Underweight** recommendation on Developed Markets Sovereign Bonds. It is possible that risk-free rates will remain rangebound in the coming weeks, pending the long-awaited central banks pivot. We are now at the lower end of the trading range, so another leg-up in rates is quite likely in the short term. Among the curves, we maintain a more negative stance on the European yield curve.

EU Core	−	**EU Periphery**	−	**US Treasury**	=	**Japanese JGB**	=

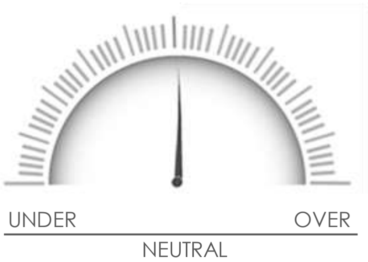
Developed Markets Corporate



We have kept our **Neutral** recommendation on Developed Markets Corporates. Spreads are at acceptable levels for investment grade bonds, whilst too narrow for high yield bonds, especially in the event of a marked slowdown or outright recession should materialize. Additionally, the potential for further decrease in risk-free rate is quite limited, unless global inflation data continues to surprise to the downside.

IG Europe	+	**IG US**	+	**HY Europe**	−	**HY US**	−

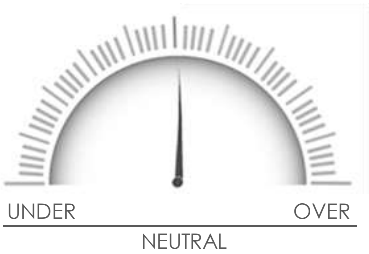
Emerging Markets



We maintained our **Neutral** recommendation on Emerging Market bonds. While emerging market bonds could benefit from a dovish pivot by central banks, which seems more likely in the near future if inflation continues to abate, they would also be exposed to downside risks in the event of a global slowdown or recession. Within the asset class, local currency bonds continue to remain in favor.

Local Currency	+	**Hard Currency IG**	−	**Hard Currency HY**	−

Commodities



We maintained our **Neutral** recommendation on Commodities. Energy and industrial commodities should benefit from the increasingly tangible easing of Covid-related restrictions in China, as well as from measures to support the Chinese economy. Precious metals could benefit from a further weakening of the dollar and a disinflationary environment, and they can serve as portfolio hedges in case of unexpected troubles, especially those that could arise from geopolitical tensions.

Precious	+	**Energy**	=	**Industrial**	=	**Agricultural**	=

Currencies

The Committee confirmed its **Neutral** view **with a bearish bias** on the US Dollar. In the short term, only a more hawkish than expected stance by the Federal Reserve seems likely to reverse the greenback's downtrend.

The view on the Euro remains **Neutral with a bullish bias**. The easing of concerns over gas prices during the winter is helping to rebuild confidence in the region, and the denial of rumors of a possible downshift in the pace of rate hikes by the ECB should allow the euro to continue to strengthen.

The view on the **Chinese Renminbi** is also confirmed **Neutral with a bullish bias**. The easing of Covid measures, the approval of measures to support the real estate sector, and the inflows of foreign investors repositioning themselves on China will likely keep the Renminbi strong.

On the **other emerging market currencies,** we maintain a **Neutral** stance taking into account both the risk of a potential global slowdown and the potential weakness of the US dollar.

Euro	=	USD	=	CNY	=	Other EM	=